Effective Date: March 21, 1997

COORDINATED ISSUE
CONSTRUCTION/REAL ESTATE INDUSTRY
PERCENTAGE OF COMPLETION METHOD
TIMING OF COST RECOGNITION

ISSUES

1. Whether, under the percentage of completion formula of I.R.C. § 460, contractors can postpone the recognition of costs they incur for the work of their subcontractors by arguing that construction contracts represent contracts for property that are not "accepted" until substantially complete, and thus postpone income.

    (a) Whether, under the economic performance rules of I.R.C. § 461(h) and the regulations thereunder, construction contracts of the type described herein usually represent contracts for several items, including services, property (raw materials), and the use of property (rental equipment).

    (b) Whether property (raw materials) provided by subcontractors are deemed accepted, within the meaning of Treas. Reg. § 1.461-4(d)(6)(iii), only upon substantial completion of the subcontract.

2. Whether, under I.R.C. § 446(e) and Treas. Reg. § 1.446-2(e)(2)(i), contractors are prohibited from changing their method of accounting for subcontractor expenses without advance consent.

CONCLUSIONS

1. Contractors cannot postpone the recognition of costs they incur for the work of their subcontractors in order to postpone income under the percentage of completion formula of section 460.

    (a) Construction contracts of the type as described herein usually represent contracts for several items, including services, property (raw materials), and the use of property (rental equipment).

    (b) Property (raw materials) provided by subcontractors are deemed accepted based upon contractual terms between

the parties.

2. Contractors are prohibited from changing their method of accounting for subcontractor expenses without advance consent.

FACTS

The taxpayer (contractor) contracted with a land owner (owner) for the construction of an office building. The contractor engaged a subcontractor to aid in the construction. The subcontractor provided raw materials as well as construction services.

The contractor (a calendar year taxpayer) uses the accrual method and must report its income from long-term contracts (such as the instant contract) under the percentage of completion method (PCM).

While contractual arrangements may vary, standard contract forms used in the construction industry always refer to work to be performed. The term "work" means the construction and services required by the contract documents, whether completed or partially complete, and includes labor, materials, equipment and services provided or to be provided by the contractor to fulfill the contractor's obligations.

The subcontractor's practice was to order materials and to perform construction services and then to send periodic bills to the contractor for the materials it had purchased and the work it had performed. After checking the bills for accuracy and verifying performance, the contractor added a 15% profit margin and requested payment from the owner. The owner, on rare occasions, adjusted downward the amount requested for inadequate services or materials. After the contractor received payment from the owner, the contractor would pay the subcontractor's bill.

Before 199x, the contractor would, upon receipt of a bill from the subcontractor, treat this liability as incurred for tax purposes. Therefore, the receipt of the subcontractor's bill before year-end would: (1) generate a tax deduction for that year; and (2) require the inclusion of additional income for that year under the cost-based formula used for recognizing income under the PCM (discussed below).

For 199x, in order to defer income, the contractor began delaying the recognition of expenses for subcontractor bills until the time that the contractor actually paid these bills, regardless of when the subcontractor's bill was received. The underlying facts of the contractual arrangements between the subcontractors and contractor remained unchanged. In effect, the contractor switched from the accrual to the cash method with respect to the subcontractor's bills without filing a request on Form 3115 for permission to change its method of accounting.

Under the contractor's new method of accounting, when the subcontractor's bill was received prior to year-end and payment on the bill was made after year-end, the contractor's recognition of income under the cost-based PCM formula was deferred. However, the contractor's new method also deferred the recognition of the underlying expenses as well. Therefore, the contractor's new method served to defer the contractor's profit margin on the subcontractor's work.

In support of its method change, the contractor argued: (1) that, under the economic performance rules, the subcontractor's bill should represent a bill for the sale of property (and that any construction services were merely incidental and could be ignored under Treas. Reg. § 1.461-4(d)(6)(iv)); (2) that, under the economic performance rules, liabilities for purchases of property are deemed incurred when the property is provided; (3) that Treas. Reg. § 1.461-4(d)(6)(iii) permits a contractor to treat property as provided to the contractor when the property is "accepted;" and (4) that the subcontractor's work was not "accepted" by the contractor until the subcontract was substantially complete.

As noted above, the contractor did not obtain the Commissioner's permission before changing its method of accounting for subcontractor bills. Instead, the contractor simply noted its accounting change on its corporate tax return. As authority for the accounting change, the contractor cited Treas. Reg. § 1.461-4(m)(2) (discussed below).

DISCUSSION

Section 460 requires most long-term contracts to be accounted for under the percentage of completion method. The PCM requires income from the contract to be reported over the life of the contract and requires contract expenses to be deducted in the year that they are incurred.

Under the PCM, the first year's contract income is computed by multiplying the contract price by the ratio of first year contract costs to estimated total contract costs. A similar formula is used in future years, taking into account the amounts of costs and income that have already been recognized in prior years.

Because the recognition of income under the PCM formula is based on the amount of costs incurred to date, deferring costs will also delay the recognition of income. Given this potential benefit, contractors (such as the contractor described above) have been attempting to postpone the time that certain costs are deemed incurred under the economic performance rules.

Generally speaking, most taxpayers wish to take deductions as soon as possible (the reverse of the situation presented here). The Code protects against abuse in this

regard by providing that an accrual basis taxpayer cannot treat the amount of any liability as incurred until the all events test is met. See, e.g., section 461(h)(4). The all events test is met with respect to an item if all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.[1] Id. See also United States v. General Dynamics Corp., 481 U.S. 239 (1987); United States v. Hughes Properties, Inc., 476 U.S. 593 (1986). Section 461(h)(1), however, provides an additional requirement for the accrual of deductions. Section 461(h)(1) provides that, for purposes of determining whether an accrual basis taxpayer can treat a liability as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. See also Treas. Reg. § 1.461-4(a)(1).

Section 461(h)(2) provides the time when economic performance is deemed to occur for various types of liabilities. With respect to liabilities for services and property provided to the taxpayer, section 461(h)(2)(A) provides that economic performance occurs as the taxpayer is provided with the services or property. See also Treas. Reg. § 1.461-4(d)(2)(i).

As discussed above, contractors have been postponing the recognition of costs by arguing that the costs of paying their subcontractors should not be deemed incurred until actual payment. The contractors' argument is based upon their assertion that the subcontracts represent contracts for the provision of property and that the property should not be deemed provided until the property is finally accepted by the land owner. The contractors cite Treas. Reg. § 1.461-4(d)(6)(iii), which provides that a contractor is permitted to treat property as provided to the contractor when the property is delivered or accepted, or when title to the property passes. The contractors assert that the property should not be treated as "accepted" until the land owner accepts the subcontractor's work. Apparently citing industry practice, the contractors assert that the land owner does not accept the subcontractor's work until the time when the subcontractor's work is substantially complete.

There are many flaws in this argument.

First, subcontractor bills of the type described above represent bills for various items, including construction services and raw materials. These bills cannot be classified, under Treas. Reg. § 1.461-4(d)(6)(iv), as solely bills for property as the contractors suggest. Therefore, economic performance is not governed solely by acceptance. Economic performance with respect to construction services occurs as the construction services are rendered.

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[1]The amount of the liability to the subcontractor may not be determinable with reasonable accuracy until the amount is billed by the subcontractor.

Second, with respect to liabilities for property (i.e., raw materials), acceptance by the owner may be irrelevant. Under the facts as presented, neither the substance or form of the contract between the land owner and contractor required such acceptance. The subcontractor appears to be working only for the contractor and, if this is the case, acceptance by the contractor would trigger economic performance with respect to this portion of the liability.

Third, acceptance of property is generally governed by contract. It may occur, for example, as the raw materials are (a) delivered to the job site; (b) billed; and (c) the bill is accepted as correct by the contractor. There may be a reasonable time for inspection provided in the contract. Further, acceptance usually occurs in stages, as periodic subcontractor bills are accepted by the contractor. It is not dependent on the subcontractor's substantial completion of the project, which could take years.

Fourth, Treas. Reg. § 1.461-4(d)(2)(ii) provides that, with respect to long-term contract expenses incurred after 1991, economic performance occurs as the services or property is provided or, if earlier, as the taxpayer makes payment.

Fifth, Treas. Reg. § 1.461-4(d)(6)(iii) provides that the method used by the contractor to determine when property is provided is a method of accounting that must comply with the rules of Treas. Reg. § 1.446-1(e). Therefore, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

These points are discussed, as necessary, in more detail below.

Subcontracts Are Usually Contracts for Services, Property, and the Use of Property

Treas. Reg. § 1.461-4(d)(6)(iv) illustrates how to treat contracts that require different services or items of property. It provides as follows:

> **If different services or items of property are required to be provided to a contractor under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided.** However, if a service or item of property to be provided to the contractor is incidental to other services or property to be provided under a contract or agreement, the contractor is not required to allocate any portion of the total contract price to the incidental service or property. For purposes of this paragraph, services or property is treated as incidental only if--
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> (A) The cost of the services or property is treated on the contractor's books

and records as part of the cost of the other services or property provided under the contract; and

(B) The aggregate cost of the services or property does not exceed 10 percent of the total contract price.

(Emphasis added). As the bolded language above illustrates, contractors are required to differentiate between property and services provided to them by each subcontractor and to recognize income and expenses accordingly. This requirement is relaxed only where the cost of the contracted property or services (the "item") is incidental. In order to be incidental, (i) the item must effectively be ignored on the contractor's books, and (ii) the aggregate cost of the item may not exceed 10 percent of the total contract price.

The examples in the regulations help to illustrate how costs for services, property, and the use of property are to be differentiated. See, e.g., Treas. Reg. § 1.461-4(d)(7), Example 3. In Example 3, W is a calendar year, accrual method contractor that manufactures tool equipment. In 1992, W enters into a long-term contract to manufacture certain equipment for X corporation. In 1992, W pays Z $50,000 to lease equipment to be used in fulfilling the contract. The one-year lease period begins on January 1, 1993. Also, in November 1992, W pays Y $100,000 for certain parts necessary to manufacture the equipment for X. The parts are provided to W in 1993. Finally, in 1993 W's employees provide W with services necessary to manufacture the equipment for X. During 1993, W pays its employees $150,000 for their services.

Even though W's contract with X was for delivery of equipment (i.e., property), Example 3 states that W incurred $50,000 for the use of property, $100,000 in costs for property, and $150,000 for services. Also, Example 3 states that the costs for property should be recognized in 1992, while the costs for services and the use of property are not recognized until 1993. Thus, for purposes of computing the percentage of completion, these costs are considered separately in determining when economic performance results.

Although Example 3 is not directly on point since Example 3 involves three separate subcontractors (instead of one), it is clear that subcontractors frequently perform several functions[2] and that each function must be separately considered under the economic performance rules. Treas. Reg. § 1.461-4(d)(6)(iv) (quoted above). In considering just how to allocate the value of a subcontractor's bill between, for example, raw materials provided and services rendered, all facts and circumstances should be considered.

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[2]See, e.g., J.P. Sheahan Associates, Inc. v. Commissioner, T.C. Memo. 1992-239, and its progeny.

Based on the above, it is unlikely that many contractors will be able to classify their subcontractors' work as entirely for the provision of property in order to postpone income under the method described above.

Timing of Acceptance of Property Component of Subcontracts

Although contractors will seldom be able to successfully argue that construction contracts represent contracts solely for property, most subcontracts will contain a component for raw materials. Therefore, the timing of acceptance is relevant for this limited purpose.

It is important to note here that subcontractors bill for raw materials (as well as for construction services) periodically. Therefore, acceptance occurs periodically and costs are incurred and accrued periodically. Thus, contractors cannot wait until substantial completion to accrue costs.

The meaning of acceptance is not defined in the regulations or in the Code. Whether raw materials have been accepted is a question to be governed by the form and substance of the contract between the contractor and the subcontractor.

One question to be answered in this context is whether acceptance of the subcontractor's raw materials by the contractor is sufficient even if the owner ultimately rejects the subcontractor's raw materials. If, under the arrangement between the contractor and the subcontractor, the contractor is still liable for payment to the subcontractor, acceptance has occurred. On the other hand, if the contractor's liability to the subcontractor is conditioned upon the owner's acceptance, this would likely govern.

Where the facts and circumstances establish that the contractor's acceptance triggers economic performance, liabilities for the raw materials should be accrued at the time the contractor accepts, as correct, each of the subcontractor's periodic bills for the raw materials. Under the facts presented above, the contractor reviews and accepts the subcontractor bills before adding a 15% profit margin and requesting payment from the owner. At the point of contractor review and acceptance, the fact and amount of the liability are certain and economic performance has occurred. Thus, the all events test is met, even though payment has not yet been made.

Unauthorized Change in Method of Accounting

Contractors have been asserting that Treas. Reg. § 1.461-4(m)(2) authorizes them to change their accounting method for subcontractor expenses. That section states in

part:

> For the first taxable year beginning after December 31, 1991, a contractor is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section...to comply with the provisions of this section.

Treas. Reg. § 1.461-4(m)(2)(i). This regulation gives automatic consent only in limited situations and only to change a contractor's method of accounting for the purpose of complying with I.R.C. § 461 and the regulations promulgated thereunder. As discussed in detail above, the method changes at issue are not in compliance with section 461. Accordingly, contractors must request advance consent under the normal procedures. See Treas. Reg. § 1.446-1(e)(2)(i).